Item 3: Tax Reform Discussion

Speaking Points

- Tax reform needs to address the need to raise additional revenue to fund the significant fiscal pressures faced by the States and Commonwealth, particularly in health, as well as looking at the efficiency with which that revenue is raised.

- We welcome the Commonwealth's willingness to examine more closely areas of significant tax expenditure such as superannuation. Reforms in this area have the potential to significantly increase the equity of the tax and transfer system and provide for opportunities to fund other tax reform.

  - While superannuation is a key component of retirement incomes and should be supported, these concessions favour high income earners, and many individuals receive little or no personal income tax benefit from their super contributions.

- NSW continues to advocate for our proposal to increase the GST rate to 15 per cent, with compensation for households earning under $100,000 in particular.

  - Compensation delivered through the tax system is likely to serve other goals, including reducing income tax rates to address bracket creep and improve incentives for participation.

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Issue: Treasurers are expected to discuss future work on tax reform, including work from the Leaders' Retreat, in the light of the views of the new Prime Minister and Commonwealth Treasurer.

Desired outcome: The Commonwealth Treasury continues to work on the Leaders' retreat tax options, including the NSW proposals. Statements by the new Prime Minister and Commonwealth Treasurer indicate the Commonwealth may be willing to look closer at broader tax reform options, including superannuation concessions, capital gain and negative gearing, which may increase the scope for tax reform. Clarification should be sought on the process and timing for the Green and White Papers.

Key reasons

The Commonwealth should continue work on the tax options from the Leaders' Retreat

- NSW has proposed raising the GST to 15 per cent with full compensation for households earning up to $100,000 and half compensation for households earning up to $155,000.
- It may be difficult to achieve this level of compensation for all households without significantly reducing the revenue gains above the proposed 50 per cent level, as the tax and transfer system is based on individuals, and many households would be 'overcompensated' to ensure full compensation for all households. Tax cuts would also likely flow to those on higher incomes.
- The design and scope of a compensation package is complicated and will require Commonwealth Treasury involvement, but little progress has been made to date. States may wish to consider contracting NATSEM to do some of this work if progress at the Commonwealth remains slow.
- QLD has proposed an alternative of raising the Medicare Levy by 2 per cent (potentially phased in over 8 years). It is not expected that there would be any significant compensation associated with this proposal given the exemptions already in the system.
- Leaders are expecting to discuss this work at the next COAG meeting in December.

The Commonwealth continues to support revenue neutral tax reform

- The new Treasurer has indicated tax reform would aim to boost productivity and growth, but would not result in an increase in the tax take and forecast ratio of tax to GDP. He has stated that all tax increases agreed by the government would be fully offset by tax cuts to ensure no net increase in the tax take.
- The States have argued that the tax take needs to rise to address significant and growing fiscal pressures from demographics, expenditure and the erosion of traditional tax bases. Health expenditures are of particular concern. Efficiencies will be important but these, or expenditure cuts, cannot bridge the gap alone.

The Commonwealth appears more willing to consider broader tax reform, including its own tax bases.

- The Commonwealth Treasurer has indicated that all options needs to be considered, including superannuation, capital gains tax and negative gearing. Superannuation appears the most likely target for any changes. It is likely the options around lowering company and personal income taxes will still be the primary focus of Commonwealth reform.

Clarification should be sought on the timing of the Green and White Paper on Taxation and the links to the Federation White Paper process

- We understand that Commonwealth Treasury is discussing options on tax reform and the timing and process of the White Paper with the new Treasurer, but there has been little information forthcoming. What does this imply about timing of the White Paper processes?

Position	Name	Ext.	Signature	Date	File number
Analyst(s)	Matthew Quillinan	4587		12/10/2015	

Supporting information

All levels of government face growing fiscal pressures driven by demographics, erosion of revenue bases and expenditure pressures, particularly in health

- At the Leaders' Retreat, a combined national fiscal gap of $45 billion in 2029-30 was presented as estimated by PWC. This reflected an estimated Commonwealth fiscal gap of around -$40 billion (from the 2015 Intergenerational report 'proposed policy' scenario) and an estimated States and Territories fiscal gap of around $85 billion.
    a. A revised Commonwealth projection from the 2015-16 budget would reduce the Commonwealth surplus by around $35 billion, reflecting a number of proposals not implemented or abandoned.
    b. Revisions to the State and Territory estimates have seen a downward revision to the State and Territory fiscal gap of around $35 billion. The main impact is from aligning projected Commonwealth transfers with estimates provided by the Commonwealth Treasury.
- These revisions leave the aggregate national fiscal gap unchanged at around $45 billion. While the Commonwealth fiscal position is worse, the fiscal gap is still borne entirely by the States and Territories, with the Commonwealth budget close to balance in 2029-30. The health fiscal gap is $35 billion in that year, entirely borne by the States. Prior to the changes in the 2014-15 Commonwealth budget, the States' health gap would have been $10 billion.

A key area of contention is the base from which to start negotiations on tax reform

- The Commonwealth does not want to revisit the cuts to health and education funding made in the 2014-15 Budget, and wants to leave States to address this funding shortfall themselves, with any discussion on tax reform to focus on potential future changes to roles and responsibilities.
- Led by NSW, the States have argued that tax reform and funding needs to address these cuts

The Commonwealth is seeking revenue neutral tax reform that increases the efficiency of the tax system, focussed on cuts to personal income tax and company tax rates

- The Commonwealth is making the case for:
    a. lower personal income tax rates, particularly in the higher brackets, to support participation
    b. addressing bracket creep, whether in part through cuts to rates or adjustment of the thresholds, or permanently through indexation of the thresholds. Bracket creep is a significant source of revenue growth for the Commonwealth.
    c. cuts to the company tax rate to maintain international competitiveness and promote foreign investment
- This agenda would increase the pressure on the Commonwealth's fiscal position. They have indicated that they would address this through decreased payments to the States, putting further pressure on the states to raise additional revenue through their own tax bases.

The Commonwealth wants the states to raise more revenue from their existing tax bases to address funding shortfalls

- The Commonwealth would like to see the states place more reliance on land tax and payroll tax.
- A broad-based land tax could be used as a replacement for transfer duty.
    a. This would significantly improve the efficiency of the tax system, as transfer duty is one of the most inefficient taxes levied at any level of Government. However, there are significant transitional issues to be faced in any such reform, particularly to address the concerns of existing property owners with no near-term plans to sell.
    b. Abolition of transfer duty and replacement with a broad based land tax should not be viewed as a vehicle for raising more revenue in the near term. Transition options could see a

significant shortfall in revenue raised compared with transfer duty, or at best would be revenue neutral.

c. In the absence of Commonwealth assistance for the transition, this should remain a matter for states to address individually. There may be an opportunity to raise potential assistance with the Commonwealth.

- The efficiency of the payroll tax system is compromised by the tax free threshold which establishes a distinction between large and small firms, resulting in a misallocation of labour and increasing production costs.
  a. Payroll tax legislation and administration are already largely harmonised, other than the rates and thresholds applied by states. Six of eight jurisdictions have adopted template legislation.
  b. Harmonisation of the rates and thresholds would significantly reduce state fiscal flexibility. Lowering the tax free threshold to zero would raise additional revenue, but would bring an additional 229,000 NSW businesses into the tax net.
  c. There is little ambition from the states for harmonisation of rates and thresholds. Victoria in particular is strongly opposed.

However, the Commonwealth to date has been unwilling to consider the tax concessions that increase the inefficiency and erosion of its own tax bases, but there are signs that this is changing

- Tax exemptions and concessions significantly reduce the efficiency of the personal income tax base, and are very costly. These include negative gearing, capital gains, superannuation and negative gearing concessions in particular.
  a. Superannuation contributions and earnings are concessionally taxed. Revenue foregone in 2017-18 is estimated at: $26.8 billion for superannuation entity earnings; $19.1 billion for employer superannuation contributions and $900 million for certain personal superannuation contributions.
  b. Revenue foregone from the capital gains tax exemption for the main residence is $47.5 billion and the capital gains tax discount for individuals and trusts is worth $7.6 billion.
- Even partially addressing these exemptions would raise additional revenue and improve the efficiency of the tax system.
- The new Commonwealth Treasurer has indicated that superannuation concessions, capital gains tax and negative gearing will be considered as part of the White Paper process. It appears superannuation would likely be the target for any changes.

States are generally in agreement as to the need to raise additional revenue to address the fiscal gap, but differ as to the potential options

- The NSW Premier has led this discussion at the recent COAG Leaders' Retreat, arguing for an increase in the GST rate to 15 per cent, with full compensation for households earning below $100,000, and 50 per cent compensation for households in the $100,000 to $155,000 bracket.
  a. This would raise gross GST of $32 billion in 2017-18 and $59 billion by 2029-30, with compensation reducing the net gains by around half.
- Leader's agreed at the recent COAG meeting to keep all Commonwealth and State tax changes on the on the table including the GST[redacted]

- Other States, particularly Queensland, have argued that additional funds could be raised by increasing the Medicare Levy. Victoria is also open to this option
    a. A 2 per cent increase in the Medicare Levy would raise around $16 billion in 2017-18.

At this stage all options should remain on the table, which will require some concessions from both the Commonwealth and States on existing public positions

- NSW has proposed the following principles:
    a. All options should remain on the table, including the rate and base of the GST and the Medicare Levy.
    b. Funding should match roles and responsibilities, including any changes stemming from the Federation White Paper process.
    c. Tax reform and funding needs to address the unilateral cuts to health and education funding made by the Commonwealth in its 2014-15 Budget.